CURRENT CONCEPTIONS OF TAXABLE INCOME—A COMMENT

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I

Professor Lowndes possesses that rare quality, disconcerting to our complacency, of presenting old cases in a new light. That he does so with lucidity and elegance makes his recent article, "Current Conceptions of Taxable Income,"[1] doubly welcome. I shall confine myself to criticizing certain aspects of his theorizing. This, however, should not obscure the fact that where he errs (and I hope to show that he does) his errors are nonetheless illuminating, for they bring to light two important features of the concept of realization which undue emphasis on the notion of income tends to obscure. If we ask, as Professor Lowndes does, what is taxable as income, instead of why is this realized gain not taxed, we fall into the error of explaining in terms of realization certain characteristics of the notion of income which have nothing to do with realization. Moreover, realization possesses the Janus-like quality of answering two questions at the same time, rather than answering first one broad question and then answering another narrower one. Awareness of this peculiar feature of realization is essential if we are to resolve many of the perplexing problems associated with the notion of income.

II

A central point in Professor Lowndes' paper, which I shall not controvert in any way, may be summarized as follows. Section 61(a) of the Internal Revenue Code is circular and does not do what it purports to do—define. It merely indicates a step in the process of computing the tax. By virtue of article I, section 8, of the Constitution, Congress has plenary power to lay taxes. A direct tax on a source of income, however, would be unconstitutional under article I if unapportioned. The function of the sixteenth amendment is to allow Congress to tax income regardless of source and without the necessity of apportionment if the tax is direct. It does not, however, dilute the plenary power under article I. Hence, the federal income tax might be applied constitutionally to a gain which is not income

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[1] 25 Ohio St. L.J. 151 (1964).

within the meaning of the sixteenth amendment and without need of apportionment if its reach were indirect. In sum, Congress derives its power to tax from article I, not from the sixteenth amendment.

Insofar as article I is concerned, the notion of gain seems virtually limitless—even emotional satisfaction could be included within its scope. But beyond this point we run into the concept of realization; and it is around this basic notion of the tax law that my differences with Professor Lowndes center. Before enlarging upon these differences, however, I should like to dispose of the constitutional aspects of realization. It is clear, I think, that the sixteenth amendment does not refer to everything that could be taxed under article I; it merely removes apportionment as a factor to be considered by Congress when taxing income in the exercise of its article I power. The income tax statute is an exercise, though not an exhaustive exercise, of that power. Hence, if Congress in section 61(a) has limited itself to income, the question, what is income, is one of statutory interpretation, and the requirement of realization is the result of judicial interpretation of the statute. For these reasons, I agree with Professor Lowndes that realization is not a constitutional requirement.

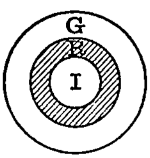
III

As my point of departure I shall take Professor Lowndes' position that the primitive concept to be considered in dealing with the question, what is income, is the notion of gain in its widest sense, which means gain taxable under the article I power. Let the symbols G, R, and I stand respectively for the class of gains taxable under the article I power, the class of realized gains, and the class of realized gains subject to the income tax under section 61(a). Assuming, as I think we must,[2] that some realized gains are not subject to the income tax, we can say that R is a sub-class of G and I is a sub-class of R. Hence in Venn diagrams we have three concentric circles of which I is the smallest and G the largest; I is included in R and R is included in G.[3] The function of realization

[2] If this assumption is not made, we are committed to the view that all items excluded from gross income by the Internal Revenue Code of 1954, §§ 101-19, would, absent those sections, be taxable under § 61(a) as income.

[3] Fig. 1:

The shaded area represents those members of R which are excluded from I for reasons unrelated to the problem of realization.



G: All gains taxable under art. I.
R: All realized gains.
I: All realized gains taxable as income under § 61(a).

is to act as a criterion for determining both whether and when a gain in G is to be admitted into R. It does not, however, determine the basis upon which members of R may be excluded from I. To settle that problem we must consider matters which are not relevant to the problem of realization. If all items of income are realized gains but some realized gains are not items of income, it follows that although gain and realization are necessary and often sufficient, neither is always sufficient, for determining whether a particular item is taxable income.[4]

As with most legal concepts there are exceptions to be considered—all realized gains are income *unless* . . . .[5] The word "unless" here cannot involve a reference to any aspect of the notion of realization, for the gain must be realized before we can ask whether it is income. Rather, it raises the question *why*—why is this realized gain not to be taxed as income; what are the reasons for excluding this admittedly realized gain from the scope of the income tax. Although extremely important, this question has nothing to do with the problem of realization. If we do not tax the gain, it must be because it is not the sort of gain which, when realized, we think of as income. In the case of a gift, obviously a realized gain to the donee, the answer to the "why" question probably lies in certain deep-seated ideas reflected in ordinary language;[6] the same may be said of bequests and devises. On the other hand, the immunity of interest on state and municipal bonds must be justified, if at all, on the basis of political policy. But whatever the reasons may be for excluding an admittedly realized gain from the scope of the income tax, they must, as Professor Lowndes argues, be furnished by Congress rather than the Treasury Department: both the asking and the answering of the "why" question should be done by Congress.[7]

Neither gain nor realization can be said to be a defining charac-

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[4] Given two propositions, p and q, if p is *necessary* for the truth of q, then q will be true *only* if p is true. An equivalent expression of this definition is: if not p implies not q, then p is *necessary* for q.

If p is *sufficient* for the truth of q, then q will be true if p is true. In other words, if it is impossible for q to be false when p is true, then p is *sufficient* for q.

We have income only if we have realized gain; if we do not have realized gain we cannot have an item of income. Thus gain and realization are *necessary* to have an item of income. Since, however, there are realized gains which are not income, gain and realization by themselves are not *sufficient* to define income.

[5] See Hart, "The Ascription of Responsibility and Rights," in Language and Logic 145 (1st Ser. Flew ed. 1951).

[6] Sneed, "A Defense of the Tax Court's Result in Prunier and Casale," 43 Cornell L.Q. 339, 351-52 (1958).

[7] Lowndes, "Current Conceptions of Taxable Income," 25 Ohio St. L.J. 151, 173 (1964).

teristic of income: although important, they are only criteria. If they are the most important elements in defining income, then we must concede that it is virtually impossible to define the concept of income in the sense of specifying its necessary and sufficient conditions. Hence we should approach the problem of what is income by asking instead why are certain members of R, the class of realized gains, excluded from membership in I, the class of realized gains subject to the income tax. Having noted this question we can now examine the notion of realized gain.

IV

Professor Lowndes distinguishes two different senses of the term "realization." In its narrow sense, the function of realization is merely one of tax accounting; it settles the question of when a gain which admittedly is income is to be taxed. In its looser sense, realization is addressed to a wider question: is there an adequate gain to sustain the tax. Although an essential requisite of income, it is probably not a constitutional requirement. Realization in this looser sense,[8] which fixes the point at which gain is transmuted into income, is to be determined in terms of economic and perhaps even emotional satisfaction. In its narrower, tax accounting sense, it becomes merely a matter of when it is administratively convenient to tax the admitted income, and this is a matter solely for Congress. Thus, for Professor Lowndes, there are two different aspects of realization which answer two different questions, neither of which is a constitutional question.

While agreeing that realization is not a constitutional requirement, I would suggest that the word "realization" denotes simply what professor Lowndes himself terms the economic objectivity of income as that term is used in section 61(a), and that this economic objectivity, denoting an event measurably changing the taxpayer's economic position, settles simultaneously two questions —both *whether* the gain is income and *when* it is to be taxed. We are concerned here solely with class R, the class of realized gains. All that is necessary for a gain to be included in R is that it be realized. If it is realized then we have settled both the "whether" and the "when" questions. The "whether" question is not whether there is a gain but whether, in Professor Lowndes' words, there is an ade-

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[8] This, according to Professor Lowndes, is the sense in which the Supreme Court spoke of realization in Eisner v. Macomber, 252 U.S. 189 (1920), and which was made explicit in Helvering v. Bruun, 309 U.S. 461 (1940). Realization in this sense connotes the completion of a transaction or a definitive change in the taxpayer's economic status. Lowndes, *supra* note 7, at 177.

quate gain to sustain the tax, the criterion of which is some sort of economic objectivity, *i.e.*, a realization, or taxable event.[9] This also fixes the point in time at which the gain is admitted into R. And such a gain is income *unless*. . . . In other words, R and I are identical unless there are reasons unrelated to the problem of realization for not taxing realized gains.[10] Hence, the word "realization" resembles what moral philosophers would term a "Janus" word—it does two jobs at once rather than first one in one sense and then a second in another sense.[11] "Whether," in the relevant sense of whether there is an adequate gain to sustain the tax, cannot be decided anterior to the question, when is it to be taxed. If the criterion of realization is satisfied, then the gain is adequate to sustain the tax and is taxable unless there are reasons unrelated to the realization problem for not taxing it.[12]

The "when" question of tax accounting—when is it administratively convenient to tax this admittedly realized gain—is thus one of the "unless" factors relating to the exclusion of members of R from I and has nothing to do with the problem of realization, *i.e.*, the inclusion of members of G in R (and therefore in I *unless*. . . .)[13]

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[9] *Ibid.*

[10] See note 3 *supra*.

[11] See Nowell-Smith, Ethics 95-100 (1954).

[12] Professor Lowndes asserts that the income tax is not limited to income as that term is used in the sixteenth amendment. For instance, a statute regulating prices might provide that over-ceiling prices paid for goods sold shall not be deductible for income tax purposes so that the gross proceeds of those sales rather than the gross profit would be included in gross income. But surely this would be simply a case of the income tax being used non-fiscally as a penalty and not as an income tax at all; if so, it hardly warrants the conclusion that the income tax *qua* tax reaches things other than income as that term is used in the sixteenth amendment. Yet I think Professor Lowndes' assertion is correct, for we are concerned under the income tax statute with what Congress means by the word "income" rather than with what that word means as used in the sixteenth amendment. If the sixteenth amendment adds nothing to the article I power, then the meaning of the word "income" in that amendment is not relevant when the question is the scope of the income tax statute; the amendment comes into play only when the application of the income tax is direct. If the word "income" in § 61(a) were limited to the meaning of that word as used in the sixteenth amendment, it would mean that the congressional power under article I, insofar as levying the income tax is concerned, would be limited by the amendment. But this, of course, is contrary to the accepted view.

[13] In United States v. Davis, 370 U.S. 65 (1962), Mr. Justice Clark states at 68: "We now turn to the threshold question of whether the transfer in issue was an appropriate occasion for taxing the accretion to the stock. There can be no doubt that Congress, as evidenced by . . . [section 61(a)], intended that the economic growth of the stock be taxed." According to my analysis, Mr. Justice Clark is saying here: (i) the accretion to the stock is a member of G, and (ii) the transfer in issue is sufficient to admit the accretion into R and therefore into I, and is thus answering the "whether-when" question of realization.

V

In his concluding remarks, Professor Lowndes reflects, with his customary diffidence, that perhaps he has "made a mistake in seeking to define taxable income in terms of some economic objectivity instead of treating it as a juridical concept resting upon considerations of policy."[14] In reply, I would suggest that the mistake, if there is one, lies in asking oneself the sort of questions that lead to such reflections. The notion of economic objectivity expresses the simple fact that we require some sort of empirical evidence—a taxable event, a transaction measurably changing the taxpayer's economic position—to support the assertion that a gain is realized. This evidence is what we refer to when we say of a gain that it is realized. Realization is thus a criterion, though not a defining characteristic, of the expression "income," which settles the dual "whether-when" question and is to be justified on grounds of administrative convenience. It is a juridical concept, and one which makes economic objectivity the criterion of income unless there are other unrelated reasons for holding to the contrary.

Professor Lowndes is not alone in suggesting that there are two temporally separate questions to be answered by two different senses of the word "realization." In a cryptic footnote to its opinion, the majority of the Court in *James v. United States*[15] alludes to, but purports to avoid passing upon, the contention of the government that the claim of right rule is a tax accounting concept invoked to determine when, and not whether, receipts constitute income. If the claim of right rule, to use Professor Lowndes' words, fixes the point at which a gain is "transmuted into income,"[16] then it is merely a name for a particular kind of realization, in which case the empirical evidence labelled "claim of right" settles both whether and when a certain kind of receipt constitutes income. In this sense, the claim of right rule really means that the possibility of subsequent defeasance of the recipient's right to keep the item in question is not to be treated as sufficient to exclude the item, a member of R, from membership in I. The trouble here, of course,

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Mr. Justice Clark then continues: "The problem confronting us is simply *when* is such accretion to be taxed. Should the economic gain be presently assessed against taxpayer, or should this assessment await a subsequent transfer of the property by the wife?" Here, the first sentence seems to indicate a tax accounting problem, the "when" being merely one of the "unless" factors of realization. The second sentence is not so clear; it could refer either to the "whether-when" question of realization or to the "when" question of tax accounting.

[14] Lowndes, *supra* note 7, at 182.

[15] 366 U.S. 213, n. 7 (1963).

[16] Lowndes, *supra* note 7, at 171.

is that the government has also successfully used the claim of right rule in a purely tax accounting sense to assert in effect that there can be no "unless" factor sufficient to exclude an actual receipt in R from membership in I.[17]

In discussing *Helvering v. Horst*,[18] Professor Lowndes suggests that the problem is not one of realization of gain but of whether there is a sufficient gain to the donor to justify taxing him. If we use the term "realization" at all here, then we are, says Professor Lowndes, using it in the broad sense of whether there is an adequate gain to sustain the tax and not in the narrow sense of when the admitted gain is to be taxed.[19] But the *Horst* case is peculiar in that it poses three questions—whether, when, and who—rather than the usual two questions of "whether" and "when" that go to the problem of realization as properly (according to my theory) understood. What, asks Professor Lowndes, constitutes the gain to the donor of a right to receive income in the future? [20] From Justice Stone's opinion it would seem to be almost solely psychological—the emotional satisfaction derived from giving. On this theory, the taxable event would be the gift, the realization answering the "whether-when" question. As the efficient cause of that taxable event, it might be logical to treat the donor, the recipient of the emotional satisfaction, as the taxable person. However, this would not explain why we should equate the donor's emotional satisfaction with the donee's economic gain; and if we should not, then the gain would not be measurable and hence the gift would lack that economic objectivity necessary to constitute a realization. Indeed, if the donee did not collect the income, there would presumably be no gain to measure or attribute to the donor.

Professor Lowndes prefers to explain *Horst* as an assignment of income case and seems to assume that this means that the gift was the taxable event.[21] The assignment theory, however, is an "as if" approach. When the interest coupon is collected by the donee, it is as if the obligor had first paid the interest to the donor who then paid it over to the donee. This would make the collection by the donee the taxable event and again it might be logical, if nothing else, to treat the efficient cause, the donee, as the taxable person. In this case there would be no valuation problem. On the other hand, the "as if" approach could also be explained as a sort of equivalence of cash theory so as to impute control to the donor of the present

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[17] See Mullock, "A Tempered Plea for Tax Accounting," 40 Taxes 649 (1962).
[18] 311 U.S. 112 (1940).
[19] Lowndes, *supra* note 7, at 180.
[20] *Id.* at 179.
[21] *Id.* at 180.

value of the income right at the time of the gift. But there would still be the problem of how to work out an equivalence of cash if the donee did not collect the coupon. Moreover, constructive receipt could not properly be invoked in *Horst* because the donor was trying not merely to postpone realization of the interest but to shift it permanently to the donee. The point is that the *Horst* problem cannot be solved by viewing it as a problem of realization or a problem of gain because it is a problem caused basically by the progressive rate structure. Are we to allow the donor to shift income from his high marginal bracket to the low marginal bracket of the donee? This question can and should be settled without the necessity of trying to answer the difficult question: how does the donor of an income right realize a gain? Administrative convenience surely requires that we wait and see what the donee collects. When we know that, we also know that a gain has been realized by the donee which, but for the gift of the right to that income, would have been realized by the donor. If we now tax the donor, we can justify doing so only by appeal to matters other than gain and realization, *i.e.*, matters of policy having to do with the progressive rate structure.[22]

VI

The foregoing suggests that perhaps a large part of the perplexity caused by the notion of income can be traced to the fact that we are asking the wrong question. Our answers to the somewhat metaphysical question, what is income, are really answers to three different questions. First the question, what empirical evidence is sufficient for us to say in a particular type of case that a gain is realized, enables us to answer the "whether-when" question of realization. However, if we have a realized gain we cannot say that it is therefore taxable as income without ignoring the defeasible nature of realization, without overlooking the indispensable word "unless." Hence the second question, the "why" question, calls for reasons or justifications which have nothing to do with realization per se, for it asks why do we not treat this admittedly realized gain as income subject to tax. But even though there are no reasons for not taxing the admittedly realized gain, there can still be a third question, to whom shall we tax it. Here we are adverting to the progressive nature of the tax rates and the consequences of income

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22 The I.R.S. position in Rev. Rul. 60-370, 1960-2 Cum. Bull. 203, is very like this suggested approach to *Horst*. *Cf.* Rev. Rul. 56-431, 1956-2 Cum. Bull. 171, where it is stated that "income is realized by the taxpayer" to the extent that his waiver of the right to receive dividends inures to the benefit of his relatives.

shifting or splitting—again a matter having nothing to do with realization.

If this analysis is correct, it does not in any way obviate the need for the various concepts—constructive receipt, equivalence of cash, dominion and control—which have been developed by the courts in their endeavors to answer the question, what is income. Rather, it means simply that all these notions are addressed to particular types of realization problems and are labels for the different kinds of empirical evidence that can be coped with administratively by an official. Tax accounting rules, on the other hand, are born of two separate things: the annual accounting concept and the fact that the taxpayer is allowed a choice of accounting methods, both of which are "unless" factors resting on matters of policy having nothing to do with the problem of realization.

VII

Somewhat wistfully Professor Lowndes concludes:

> Perhaps a fitting approach to taxable income is to think of it as an occasion on which it is just and socially sensible to impose liability for an income tax, rather than as some particular kind of economic entity. From this point of view the constitutionality of taxing a particular item as income resolves itself into an inquiry into whether Congress has acted reasonably in imposing the tax. The question of construing the word "income" in a tax statute to include a particular gain becomes a question of whether or not such a construction will achieve a just and socially desirable result.[23]

This presents some interesting problems. First, on what basis would a court determine whether Congress had acted reasonably in taxing a particular item, and, second, what does it mean to say of the inclusion of a particular gain within the scope of the notion of income that it will achieve a just and socially desirable result?

From Professor Lowndes' comment on *Burnet v. Wells*[24] it would seem that he has in mind a due process approach—Congress must not play the despot.[25] But what would be the criterion of

23 Lowndes, *supra* note 7, at 182.

24 289 U.S. 670 (1933).

25 Lowndes, *supra* note 7, at 164. In commenting on Edwards v. Cuba R.R. Co., 268 U.S. 628 (1925), Professor Lowndes observes that if a contribution to capital is not income it is a kind of gain that approaches income closely enough to be reasonably taxable under the income tax. By reasonably taxable, Professor Lowndes then tells us, he means taxable as income under the income tax if this is a *reasonable* thing to do. Lowndes, *supra* note 7, at 165. I have suggested that any realized gain is income *unless*. . . . Now the reason or justification called for by the word "unless" might

reasonableness? And why, if the elected Congress decides to tax a particular gain, should despotism be a relevant consideration for a court in construing the statute? Moreover, to suggest that whether the statutory notion of income applies to a particular gain depends upon whether it will achieve a just result is equally odd. The juridical notion of justice centers on the idea that like cases must be treated alike, while recognizing that the criteria for determining when, for any given purpose, cases are alike will vary.[26] As long as a particular type of gain is taxed in the hands of each taxpayer who receives such a gain, legal justice is done. If we wish to go further and say that to tax this admittedly taxable gain in this particular case would be unjust, then we are deciding a particular legal case on purely moral grounds. And if we add social desirability as another relevant consideration, then we are injecting a further non-legal factor.

No doubt it is open to Congress to take both justice and social desirability into account in framing the tax laws. But surely it is a most radical proposal to suggest that after Congress has said what gains are to be taxed, the courts should sit in moral and social judgment on the decree of Congress as applied to a particular case. Yet on reflection it must be admitted that the vision induced by Professor Lowndes' theorizing is quite delightful. With justice and social desirability as criteria, we could throw away the Code, regulations, rulings, and decisions. The tax court would be transformed into a Lyceum wherein Plato and Aristotle would rule supreme. Tax accountants and tax lawyers would become a fast-vanishing breed as philosophers (aided by law professors?) once more assumed their rightful role as arbiters of the good, the beautiful, and the just.

conceivably be based on notions of due process. See, *e.g.*, Simmons v. United States, 308 F.2d 160 (4th Cir. 1962). But that does not mean that the word "unless" itself is required by considerations of due process. Rather it is required by the fact that realization and gain though both necessary and often sufficient are not always sufficient for the notion of income.

[26] Hart, The Concept of Law 156 (1961); Hart, "Georgio del Vecchio's 'Justice,'" 28 Philosophy 348 (1953).